Risk Adjusting the Culture of Global Finance in the Information Age

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HIGHLIGHTS

In this article, Allan Grody discusses the history and evolution of the underlying culture and practices of the financial industry that led up to the recent financial system crisis. Against the backdrop of the lack of adequate standards and technology that would have allowed the private or public sectors to at least understand the consequences of actions taken in the run up to the crisis, Allan makes a cogent and clear case for the types of financial data infrastructure facilities and capabilities that are needed in order to "fix the plumbing" of the financial system.

Seeding the Culture

The concept of "culture" is traditionally connected to the idea of national or ethnic culture. But "culture" is often referred to in a large range of financial areas: we hear about corporate culture; in risk management we speak of the risk culture of the organization; in traded markets we speak of the culture of participants in behavioral finance terms; in those same markets we speak of the market makers and client facing representatives as having a sales culture; in general we see the culture of finance on all sides as a culture of fear in one case and greed in the other.

The bifurcation of motivation into these two opposing forces - fear and greed is what gives us a buyer for every seller and a winner for every loser. It also creates the liquidity necessary in market pricing - the rapid transformation of one view to the other, a culture of fear and greed that is transitory and moving at a different pace in each human player. It also gives us arbitrage opportunities across asset classes, across geographies, and between markets, helping to keep economic equilibrium.

When either fear or greed is universally shared it gives us gridlock - no buyer for any seller, no price discovery therefore no values on our intangible financial assets, and no liquidity. Worse, it leaves us in financial crisis, with a universal fear

that the global economy is badly broken. That is our current state!

Culture is a product of shared beliefs that gets played out every day in one's daily life, whether the private one or the corporate one. Some would even say the optimal state of a culture is to be common to both of those lives. That culture cannot be created overnight is obvious; it's the result of a consistent, multi-year, open exchange of views, healthy skepticism and questioning of widely-held beliefs. It gets played out in a parent shaping a child's national or ethnic culture, in a coach or dance instructor's teaching discipline, in a pastor or rabbi instilling moral and ethical values, and in mentor's shaping of an apprentice's corporate culture.

In the enduring corporate cultures, we see a recognition of common beliefs of one's private and business life. It starts at the recruiting level, moves on through the training programs, gets codified in performance appraisals, and finally, gets melded at a one-to-one level with a mentor system that passes the culture from one generation to the next.

What skews culture in the financial industry is a widely-held belief that winning is all that matters. That greed has no counterpoint in fear. That if I get to the finish line by any means I can take it off the table and never look back. In Nick Dunbar's great book, the Devil's Derivatives he talks about this as the transformation of a bank culture from "hate to lose" to "love to win".

This cultural transformation was also enabled by the progressive complexity of engineered financial products relying on the technology of the information age and the embrace of the mathematics of particle physics. I will talk to that in a few minutes.

Culture Gone Awry

The personification of the greed culture was described in a NY Times editorial by a young recruit of 14 years vintage at one of the leading investment banks. He announced publicly upon resigning that when the history books are written on his company, they may reflect that the current chief executive officer and the president lost hold of the firm's culture on their watch. He went on to say he believed that the decline in the firm's moral fiber represented the single most serious threat to its long-run survival.

I would like to now describe my own experience with shaping corporate culture as a means to take up what was implied in that editorial. I lived in a nearly 150 year old private partnership for quite some time as it grew and became global. I and my partners increasingly became globe-trotting rain makers. We became increasingly detached, ever so slowly, from the personal mentoring that was so critical to communicating a culture across decades let alone generations. We kept pace with our clients' globalization aspirations, and spent increasingly more time chasing and competing for new business and increasingly less time in preserving the culture we had inherited. We recognized this change and hired academics and professional educators to teach ethics and imbue our culture, but it wasn't the same. We weren't alone. Our clients, great financial institutions steeped in century's long "vision and values" cultures, hired the same outside mentors and tried similar programs.

We became enamored with size and money although nowhere near what came to be the excessive incentive compensation schemes that drove the financial engineering/ investment banks after they went public and took other people's money. One of the noble professions own, Arthur Andersen became the poster boy for such excesses and was the seed of its untimely demise.

In 1999 Goldman Sachs, one of the last holdouts from an era of public offerings of investment banks, a movement that started in the 1970's by the Donaldson, Lufkin & Jenrette partnership, went public. The growing globalization of the firm, the acquisition of a traditional commodity trading firm, J. Aron & Co. and the public offering of shares in Goldman came together. Detaching the family/ partners' money and substituting it with other people's money – that was the tipping point in a culture change at Goldman that the young recruit I referenced earlier observed but incorrectly diagnosed. The fact that the Goldman partnership debated the decision to go public for decades and was one of the last of the great investment partnerships to go public says more about its high moral standards than a single employee's disgruntled observations on his way out the door.

In my role as advisor to many of these Wall Street partnerships, I saw the way the partners would caucus at their Monday morning meetings, deciding the market view for the week and whose trading desk would be given the partnership's money for investing and trading. They sat individually in glass windowed offices around the trading room or sat all together in the trading room. They moved back and forth between the two. Back then the moving ticker, an elaborate marvel of electronic switches and lights was the focal point of all the action. It is still today but in more digitized electronic form. The green screens of the Quotron terminals, the early forerunner of the Bloomberg terminal was the prestigious toy each partner acquired to facilitate watching markets ... and how they fared in their trading.

There was a feeling of closeness in the firms back then - a sense of intimacy felt both culturally and physically. The personal mentoring was easier in this environment. Culture was transmitted almost effortlessly. In seeing a transgression it could easily be remedied. Then it began to change, slowly at first, then more rapidly through a volatile mix of a partnership pushed by regulation out of its long standing legally permit-

ted monopolistic pricing habits into an increasingly competitive business model. Globalization removed the intimacy in which culture is best transmitted. Partners taking their own capital out of the business through a public sale of its shares removed the tie to their best risk control, putting their own money on the line.

The final nail in the coffin of any semblance of a suitable moral and ethical culture was the anonymity and claims of "I didn't know" permitted by the evolving technological complexity, black box culture, and pseudo-science of risk management that grew up in the now Too-Big-to-Fail giant financial institutions.

Restoring the lost culture of the congenial partnership business model in the investment banking business will not be easy. But blaming Goldman's changes on one or two men and the inference of pervasive moral hazard in the firm is wrong. The easy sightings and explanations of a young man with a single decade of context should be considered against the observations I have conveyed about the more complex forces of competition and change that evolved over decades and generations.

Fixing the Baseline

The culture of the financial services industry is now left to be reengineered in the context of a very complex information technology and communication environment. The prevalent short term performance and incentive culture that has characterized much of finance in the last half century will be muted by the longer-term engineering culture that is needed to evolve our plumbing and factory, improve our risk models, rethink our performance and incentive compensation systems, and thereby collectively risk adjust the financial system. It is the expectation by regulators, the public at-large and industry members alike that nothing short of a fundamental cultural change is needed to get us through to the next stage in the evolution of our capital and contract markets.

The "living will" concoction to accommodate the Too-Big-to-Fail (TBTF) concern could be used as the catalyst for such change. It provides a map of the existing environment in which a structural redesign can be affected. A living will can be used to incubate a more uplifting concept, that of reengineering these same TBTF financial institution as a counterpoint to the death of a company implied by drafting a will. We have both in the US and in the UK living will legislation that we can tweak.

Definitions of assets including technology, data, algorithms, computer programs, and procedures can be inventoried and their interconnections internally and externally documented. How we then go from the current Rube-Goldberg, and Heath Robinson structures to the new architecture can either be through regulatory cajoling around the edges of the current legislation or

more specifically through adding on an "option" to the living will of a reengineering plan to survive in perpetuity. After all the limited liability organizational form was conceived not to have a limited life span as a human partnership or sole-proprietorship. I believe we have to incend Too -Big-to-Fail banks to get back on a path toward survival in perpetuity.

Respecting Bigness

The precursor to the TBTFs, the "financial supermarket", goes back to the early 1980's, 1981 in fact, the year they sold Wall Street for the first time to all manner of outsiders – Shearson to American Express, Dean Witter to Sears, Bache to Prudential.

To understand just what was going on back then, we need to travel back to that time. It was the dawn of the era of emerging awareness of the demographic impact of the baby boomers. A new personalized computing technology was combining with telephone networks, satellites and cable boxes. It was the dawn of both the information age and the financial revolution that promised time conscious, convenience oriented, financially savvy, technology literate baby boomers the fulfillment of their dreams.

The Information Age, led by fiber and the Internet, further propelled the industry to its current state of advanced use of information technology. Financial institutions employed baby boomers to trade by computer, to devise mathematical models, to trade in various financial markets separate and distinct, connected and interrelated, with sub-second speeds. All the while the infrastructure of the factory - the back, middle and front office, along with the risk models and regulatory oversight failed to keep pace. The industry poured huge amounts of money into this increasingly complex infrastructure to just keep the plumbing from exploding.

The architects of that era were strategists and acquirers. They failed to be true architects, to lay out the blueprints upon which these financial conglomerates were to be built. The business silo model for controlling the enormous growth that evolved was a model that proved ineffective when attempting to pull together resources to reengineer the pilings upon which the whole edifice was erected.

These giant financial conglomerations were built one acquisition atop another, always teetering at the edges of an infrastructure needing rebuilding or the whole thing would collapse. The business model did prove faulty, not because it was wrong to be big, global and diversified - that is where the clients were going as well - but because the revenue was pouring in faster than internal systems could be rebuilt at a time when massive infrastructure projects were being mandated by external events. Remember CLS Bank and Omgeo, or the Y2K project, or the euro implementation?

Within this context there were too many black boxes acquired from merged companies piled one atop the other in no particular order. No CEO, auditor or regulator was able to see into it. Gaining concurrence to fund a redo of the infrastructure required each P&L owner, and there were many, to agree to give up some of their profits (which translated into their direct compensation) for the good of the enterprise. That was not the culture they grew up in.

That the blue print for these financial behemoths was missing is unquestioned. How then can regulators guided by a hastily prepared living-will dismantle or recover them from serious capital depletion or failure? A living will requires the drafter to a have a full inventory of assets and liabilities, systems and interconnections, as well as entanglements with all outside facilities and organizations.

We will surely pull the wrong brick or tug the wrong pipe and topple the whole edifice. Best to place society's bet on slowly reengineering TBTFs. This effort is made more doable now that the G20 has approved a long missing global identification system for financial market participants and the products they own, trade and process. It is amazing that the industry and its regulators survived without a globally unique legal entity identifier or a unique product identifier as the means to aggregate and view financial transactions electronically. Perhaps industry spent too much money on short-term fixes in keeping with the short term mind set of a performance and incentive compensation culture and regulators too easily nodded in approval and issued no-action letters.

The Point of it All – How to Risk Adjust the Culture of Global Finance

To conclude, let me leave you with a few simple thoughts on how we can get on with developing a risk adjusted financial culture:

1. Govern your business around the principles of doing the right things: first, for your customers; then your shareholders and community; then your people; and finally your management team.
2. Vet new ideas through risk management and audit committees, not the marketing and sales department.
3. Don't let the marketing materials, slides shows or brochures out the door until the technology, risk management and operations departments sign off.
4. Manage incentive compensation around risk-adjusted performance metrics.
5. If you can't explain an idea, product or technique that your firm uses, lose it. And, finally
6. The success of the three pillars of your business - your capital, your people, and your data - all rest on the back of a fourth – information technology. Give it its due.

Finally, develop a plan around a culture that lives within its means, respects profits for those who place their own capital at risk...one that builds its risk management systems and transparency tools for regulators on an information platform that is FIT FOR PURPOSE – one that:

1. Supports a long needed global identification system now being developed at the G20's Financial Stability Board.... the first step is the Global Legal Entity Identifier system I mentioned earlier,
2. Sets up non-strategic referential data as a standard for an industry-led "golden copy".... I call it a Central Counterparty for Data Management, this too is on its way through the FSB and the work of that goes on here around semantic languages,
3. Begins to risk adjust the financial system using both the global identifiers and new risk meth-

ods that suit the new understanding that came from the financial crisis,

4. Utilizes this central data repository and global identification system built around an external intelligent, federated network to start the journey of reengineering financial institutions... on top of this shared global data and identification utility... a World Wide Web for the financial industry.

5. We can then get on to tying compensation to the risk of new products...to the reality that shareholders and taxpayers come first...and to the recognition of new techniques tied to risk adjusted returns and performance. Here is where the new math and models of behavioral finance should be tried out first.

6. Finally, to get on with re-engaging accounting with risk and finance.... tying the formal books and records of the firm to new techniques.... simpler techniques...that leave human wisdom and judgment at the center of our future risk regime.